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In the Supreme Court of the United States

OCTOBER TERM, 1992

BROWN-FORMAN CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether inclusion of federal excise taxes in determining worldwide profitability for purposes of the "Overall Profit Percentage Limitation" contained in Treasury Regulations Section 1.994-2(b)(3) properly implements Section 994(b) of the Internal Revenue Code, 26 U.S.C. 994(b).

TABLE OF CONTENTS

	Page
Opinions below	1
Jurisdiction	1
Statement	2
Argument	6
Conclusion	10

TABLE OF AUTHORITIES

Cases:

Commissioner v. *Portland Cement Co.*, 450 U.S. 156 (1981)	7
Commissioner v. *South Texas Lumber Co.*, 333 U.S. 496 (1948)	7
Dow Corning Corp. v. *United States*, 22 Cl. Ct. 184 (1990), appeal pending, No. 50-5150 (Fed. Cir.)	6
National Muffler Dealers Ass'n v. *United States*, 440 U.S. 472 (1979)	7
Rowan Cos. v. *United States*, 452 U.S. 247 (1981)	7
United States v. *Correll*, 389 U.S. 299 (1967)	7
United States v. *Vogel Fertilizer Co.*, 455 U.S. 16 (1982)	7

Statutes and regulations:

Internal Revenue Code (26 U.S.C.):	
§§ 921-927	3
§ 925(b)(2)	3
§ 991	2
§§ 991-997	2
§ 992	2
§ 994(a)	3
§ 994(a)(2)	3
§ 994(b)(2)	3
§ 995(a)	2

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-13a) is reported at 955 F.2d 1037. The opinion of the Tax Court (Pet. App. 14a-54a) is reported at 94 T.C. 919.

JURISDICTION

The judgment of the court of appeals was entered on February 3, 1992. The petition for rehearing was denied on March 17, 1992 (Pet. App. 55a). The petition for writ of certiorari was filed on June 15, 1992. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner is the transferee of the assets of Southern Comfort Corporation. During 1981 and 1983, Southern Comfort Corporation was engaged in the production and sale of Southern Comfort liqueur for domestic consumption and for export to foreign markets. The Southern Comfort liqueur was subject to the federal excise tax on the production of distilled spirits at the then-current rate of $10.50 per proof gallon. See 26 U.S.C. 5001(a) (1976). Exported distilled spirits, however, were relieved of the excise tax. See 26 U.S.C. 5005(e), 5214(a)(4). Export sales of Southern Comfort were conducted on a commission basis through Jack Daniel International Sales Corporation (Jack Daniel), a second-level subsidiary of petitioner and a Domestic International Sales Corporation (DISC) as defined by Section 992 of the Internal Revenue Code, 26 U.S.C. 992 (Pet. App. 1a-2a, 15a, 16a-19a).

Section 501 of the Revenue Act of 1971, Pub. L. No. 92-178, 85 Stat. 535-549, added the Domestic International Sales Corporations (DISC) provisions (Sections 991-997) to the Internal Revenue Code to encourage export sales of domestic products. The DISC itself—which is ordinarily a corporate shell by or through which export sales are made—is not subject to tax. 26 U.S.C. 991. Instead, the DISC's shareholder is taxed directly on a specified percentage of the DISC's current income as if that amount had been distributed as a dividend at the end of the taxable year. 26 U.S.C. 995(a). The remainder of the DISC's income is not taxed until it is actually distributed, the shareholder disposes of its DISC stock, or the DISC loses its special status. 26 U.S.C. 995(b), (c). The larger the share of income attributed to the DISC, the larger the share of income tax that is deferred (Pet. App. 2a). This case concerns the calculation of the

share of income from foreign sales of Southern Comfort liqueur that is to be allocated to the DISC that conducted those sales.

In Section 994(a), Congress provided three methods for determining the amount of income to be attributed to a DISC from its sale of property. Under Section 994(a)(2), in the event of sales of export property to the DISC and resales by it, the taxable incomes of the DISC and of the seller are to be determined based upon an imputed transfer price (without regard to the price actually charged) that would allow the DISC to derive taxable income attributable to the sales in an amount not exceeding 50% of the combined taxable incomes of the DISC and of its supplier related to the qualified export receipts plus 10% of the export promotion expenses of the DISC attributable to those receipts. Combined taxable income is calculated for this purpose by deducting the full costs incurred in generating the export income from the export receipts. Treas. Reg. § 1.994-1(c)(6). When, as in this case, export sales are made by the DISC on a *commission* basis, the taxable income of the DISC is to be determined pursuant to Regulations prescribed by the Secretary consistent with the rules set forth in Section 994(a). See 26 U.S.C. 994(b)(2).[1]

As the court of appeals noted (Pet. App. 8a n.3), the legislative history of Section 994(b)(2) indicates that, when the DISC is seeking to establish or maintain an export market, combined taxable income on the sale of export property should reflect a profit equal to the profit that

[1] As the Tax Court noted (Pet. App. 47a-49a), Congress limited the DISC provisions and largely replaced them with the Foreign Sales Corporations provisions (26 U.S.C. 921-927) in Sections 801-805 of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 985-1003. The new provisions, however, incorporate for Foreign Sales Corporations the provisions of Section 994(b)(2) that had been applicable to DISCs. See 26 U.S.C. 925(b)(2).

the DISC and the related party would earn if they took into account only the marginal or variable costs of producing and selling the export property. Treasury Regulation § 1.994-2 (Pet. App. 60a-68a) responds to that legislative directive. Section 1.994-2(b)(3) of the Regulation establishes an "[o]verall profit percentage limitation" (OPPL) and provides that the "appropriate cases" for use of marginal costing are cases in which the percentage of profit from export sales does not exceed the overall profit percentage. Section 1.994-2(c)(2) of the Regulation defines "overall profit percentage" as follows:

> (2) *Overall profit percentage.* (i) For purposes of this section, the overall profit percentage for a taxable year of the DISC for a product or product line is the percentage which—
>
> (a) The combined taxable income of the DISC and its related supplier plus all other taxable income of its related supplier from all sales (domestic and foreign) of such product or product line during the DISC's taxable year, computed under the full costing method, is of
>
> (b) The total gross receipts (determined under § 1.993-6) from all such sales.

The Tax Court correctly observed that "[t]he OPPL renders the marginal costing method beneficial only to those taxpayers whose profit margin for export sales—determined under a full costing method—is less than their worldwide profit margin with respect to sales of such product or product line" (Pet. App. 45a).

2. In computing combined taxable income from export sales of Southern Comfort liqueur, petitioner sought to invoke the marginal costing rules set forth in Treasury Regulations § 1.994-2. Petitioner's overall profit *percentage* for its 1981 Southern Comfort world-wide sales

was 12.76% (Pet. 13, Table 2, Col. A; $6.16 divided by $48.26). Petitioner, however, seeks to use a profit percentage of 22.5% (Pet. 13, Table 2, Col. B; $5.61 divided by $24.93). Petitioner obtains this different profit percentage by declining to treat the domestic excise taxes it pays on its domestic production as part of its worldwide costs of production.[2] Petitioner asserts that any consideration of excise taxes in the calculation of its overall profit percentage is improper because "[t]he Commissioner does not have any authority to allocate to *export* sales costs (here federal excise taxes) that are incurred exclusively in producing the *domestic* product" (Pet. 8-9).

The Tax Court upheld the Treasury Regulation and its application to petitioner in this case. The court observed that the Regulation properly (Pet. App. 45a-46a):

> excludes from marginal costing taxpayers who logically would not need special tax incentives to be encouraged to export—i.e., those taxpayers whose export profit margin already is higher than their worldwide profit margin with respect to the product in question.

3. The court of appeals affirmed. The court rejected petitioner's contention that the OPPL regulation allocates the cost of excise taxes to export sales (Pet. App. 7a):

> This argument is misconceived. The OPPL does not allocate costs; it serves to limit the profitability un-

[2] For purposes of illustration, we have joined petitioner in referring to the figures in Table 2 at Pet. 13, which reflect only petitioner's sales of Southern Comfort liqueur. The actual overall percentage used in the computation for entry of decision in the Tax Court included the sales of Jack Daniel, and is 27.86%, compared with petitioner's claim for 43.88%. See Table 1 at Pet. 5.

der marginal costing of a DISC and its related supplier to the related supplier's worldwide profitability. Because no reduction for excise taxes is allowed, this cost decreases worldwide profitability and limits the combined taxable income of the DISC and its related supplier. However, the same is true for any other exclusively domestic cost.

ARGUMENT

The decision of the court of appeals is correct and, as petitioner concedes (Pet. 8), does not conflict with any decision of this Court or of any other court of appeals.[3] Further review is therefore not warranted.

1. Although petitioner vaguely contends (Pet. 7-8) that "[t]his case is one of a series that illustrate a concerted effort by the Internal Revenue Service to restrict and deny DISC benefits legitimately authorized by Congress," petitioner does not challenge the validity of the Treasury Regulation at issue in this case.[4] To the

[3] Petitioner's suggestion (Pet. 8) that the Court should defer consideration of its petition pending the decision of the Federal Circuit in *Dow Corning Corp.* v. *United States*, 22 Cl. Ct. 184 (1990), appeal pending, No. 90-5150, is misplaced. The taxpayer in *Dow* challenges the validity of the OPPL concept, whereas Southern Comfort "does not disagree with the OPPL regulations and concept in general" (Pet. 6) and instead challenges the inclusion of federal excise taxes as one element of cost in computing the OPPL. Moreover, the Claims Court ruled against the taxpayer in *Dow*. There is no reason to believe that the Federal Circuit will reach any different conclusion.

[4] The cases cited by petitioner (Pet. 7) in which DISC regulations were held invalid are all, in the words of the Tax Court (Pet. App. 44a-45a), "distinguishable from the instant case in that they all involve interpretative regulations which improperly imposed additional requirements or created additional exceptions with respect to unambiguous statutory provisions. * * * The instant case, unlike such cases, presents a situation in which the

contrary, petitioner ultimately concedes (Pet. 6) that it "does not disagree with the OPPL regulations and concept in general." It is, in any event, the settled principle that "[t]he role of the judiciary in cases of this sort begins and ends with assuring that the Commissioner's regulations fall within his authority to implement the congressional mandate in some reasonable manner." *United States* v. *Correll*, 389 U.S. 299, 307 (1967); see *National Muffler Dealers Ass'n* v. *United States*, 440 U.S. 472, 479 (1979). "Treasury regulations 'must be sustained unless unreasonable and plainly inconsistent with the revenue statutes'." *Commissioner* v. *Portland Cement Co.*, 450 U.S. 156, 169 (1981), quoting *Commissioner* v. *South Texas Lumber Co.*, 333 U.S. 496, 501 (1948). Any regulation, whether "interpretive" or "legislative," is valid if it "harmonizes with the statute's 'origin and purpose.'" *United States* v. *Vogel Fertilizer Co.*, 455 U.S. 16, 26 (1982). In situations (such as here) where Congress has directed the Secretary to promulgate rules to implement terms and concepts that lack specific definition, the Secretary has even greater latitude than in situations where the terms used by Congress have well defined meanings. *National Muffler Dealers Ass'n* v. *United States*, 440 U.S. at 476-477. See also *Rowan Cos.* v. *United States*, 452 U.S. 247, 253 (1981) ("where the Commissioner acts under specific authority, our primary inquiry is whether the interpretation or method is within the delegation of authority").

2. Although accepting the validity of the OPPL scheme as set forth in Section 1.994-2(b) of the Treasury Regulations, petitioner contends that the inclusion of the federal excise taxes in computing the OPPL exceeds

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statute specifically authorizes the Secretary of the Treasury to create rules and in which there is no conflict with an unambiguous term of the statute."

the Commissioner's authority because it allocates excise taxes to export sales (Pet. 8-14). As the court of appeals pointed out, "[t]his argument is misconceived" (Pet. App. 7a).

Petitioner's excise tax liability related to its domestic sales, and petitioner excluded those taxes in computing its taxable income from domestic sales. Petitioner incurred no excise tax on its export sales, and the OPPL allocated none to the DISC. The OPPL is computed by multiplying the worldwide profit percentage by the total gross receipts from export sales of the DISC and its related supplier. The OPPL is, as its name would suggest, a *limitation* applied to the result of another calculation as part of a two-step process. In the first step, one computes the combined taxable income attributable to the export sales; in the next step, one determines whether the combined taxable income so computed exceeds the OPPL.

As for the first step, in computing the combined taxable income attributable to export sales, petitioner was *not* required to take account of any item other than the marginal costs of producing the export property. Those costs did not include federal excise taxes. As for the second step, the computation of worldwide profitability under the OPPL regulation took account of domestic excise taxes, as it would any other purely domestic cost of production. This does not mean, however, that the Commissioner allocated domestic costs to export sales. In the words of the court of appeals, "[a]lthough a particular cost of doing business is exclusively domestic, it may nevertheless be a valid component of worldwide profitability [for] federal excise taxes are properly viewed as a cost of doing business" (Pet. App. 8a). In this same manner, *all* domestic costs could be said to limit indirectly the combined taxable income attributable to export sales that may be calculated using the marginal

costing method.[5] The calculation of this *limitation* on the use of the marginal costing method does not, however, involve an allocation of domestic costs (specifically, federal excise taxes) to reduce the actual income derived from export sales, as petitioner erroneously contends.

3. Petitioner further errs in contending that its "position does take excise taxes into account in computing worldwide profitability" (Pet. 13). Petitioner bases this claim on the incorrect assertion that the parties have stipulated that the agreed worldwide profit figure of $6.16 per case (Table 2, Col A, line 5) is the same as the OPPL computed under the Regulation (Pet. 13). This is simply not correct.[6]

Under the Regulation, the worldwide *dollar* profit (combined taxable income) is not the end of the journey, but a step on the way. The overall profit *percentage* must next be arithmetically derived. By way of illustration, using the figures in Table 2, Col. A (Pet. 13), the relevant resulting overall profit *percentage* is 12.76% ($6.16 in profit divided by $48.26 in sales). The agreed export sales figure of $24.93 per case must then be multiplied by this *percentage* to determine the OPPL of $3.18 per case ($24.93 times 12.76% equals $3.18). Petitioner's statement that the "$5.61 of *export* profit [as computed by Southern Comfort] does not exceed the agreed

[5] Indeed, that is the very function of the overall profit percentage limitation. See Treas. Reg. §§ 1.994-2(b)(3), 1.994-2(e) (Examples 1 & 2).

[6] The supposed "allocation" of excise taxes to export sales by the Commissioner on line 2, Col. C of Table 2 (Pet. 13), is a factual inaccuracy in petitioner's brief. The stipulation (Exh. 44-AR, Col. 3, lines 11-20 (C.A. App. 142)), which is the supposed "source" for this part of Table 2 (see Pet. 13), merely lists per case sales of $24.93, total costs of $21.74, and taxable income of $3.18. The "allocation" of $2.43 per case in excise taxes is not drawn from the Commissioner's stipulation.

worldwide profit of $6.16" (Pet. 13) is simply irrelevant. As the Tax Court correctly noted (Pet. App. 45a-46a), it is the overall profit percentage, not the overall dollar profit, that is the key factor in computing and applying the OPPL.

When the overall dollar profit of $6.16 per case is converted to a percentage of sales, the fallacy in petitioner's argument becomes apparent. Petitioner's profit calculation of $5.61 on sales of $24.93 per case translates into a profit percentage of 22.50% ($5.61 divided by $24.93) on its export sales, almost double the per case overall profit percentage of 12.76% that may be derived from the agreed numbers. Petitioner's claim that the Commissioner "has allocated excise taxes to export sales" (Pet. 13) is thus based on its misreading of the facts, coupled with its misunderstanding of the Regulation.

4. There is no conflict among the circuits or other reason warranting further review.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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